

ANNUAL REPORT

CALVET INSURANCE PLANS

**Report Pursuant to
Military and Veterans Code
Sections 987.2; 989.1 and 989.7**

Fiscal Year 2009-2010

**Submitted:
September 1, 2010**

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INSURANCE COVERAGE UNDER THE CALVET LOAN PROGRAM

Introduction

The California Department of Veteran Affairs (CDVA or Department) insurance report is submitted in compliance with Sections 987.2; 989.1 and 989.7 of the Military and Veterans Code of the State of California (the Code), as amended by the Statutes of 2009, Chapter 502. Those statutes require CDVA to report annually to the Legislature regarding any insurance coverage implemented or required by it. This includes any insurance purchased to support or supplement the Indemnity Fund, established under Article 3.8 of the Code, entitled Disaster Indemnity; and any insurance purchased to support or supplement the Pooled Self-Insurance Fund, established under Article 3.7 of the Code.

This report provides information on the following plans for protection of CalVet purchasers and the CDVA against unforeseen occurrences:

**FIRE AND HAZARD REAL PROPERTY INSURANCE
DISASTER INDEMNITY COVERAGE
LIFE AND DISABILITY COVERAGE
PRIMARY MORTGAGE INSURANCE**

Executive Summary

All of the Home Protection programs are financially stable, and will continue to be solvent for the next five years. Only minor revisions will be made to improve program compliance and performance.

CalVet Pooled Self Insurance Fund

In October 2009 the Governor signed AB 1051, Fletcher, which was sponsored by the Department and established the CalVet Pooled Self-Insurance Fund in Military & Veterans Code Sections 989 and 989.1. This statute provides that the four CalVet self insured programs will be pooled. This Pooled Fund was implemented on July 1, 2010 and it will help to maintain the stability of the CalVet Home Loan program.

CalVet Property Claims Adjuster

In March, the Department initiated a competitive bid for the CalVet Property Claims Adjuster. This process will be completed in August and the successful bidder will start a new three year contract on October 31, 2010.

Property Insurance Premiums

The property insurance premium charged by CDVA to CalVet contract holders has not changed in the past year. The current annual rate for the Fire & Hazard Insurance coverage is \$1.45 per \$1,000 of insured value, and the Disaster Indemnity Coverage (Earthquake & Flood) is \$1.50 for a total rate of \$2.95 per \$1,000 of insured property value. This insurance rate is competitive and provides broader coverage than most property insurance carriers provide to homeowners.

Self-Funded Life and Disability Program

The liability for the legacy (vested) Self-Funded Life and Disability program is fully funded based on the current actuarial estimates. We will continue to monitor this benefit to make sure that the mortgage is paid for these disabled CalVet contract holders.

Primary Mortgage Insurance

During 2008, all commercial Primary Mortgage Insurance (PMI) carriers in California were downgraded by the rating agencies, and the few with acceptable ratings refused to write PMI coverage on homes in California. This makes PMI companies of little value in supporting CalVet

bond ratings. As a result, the Department is continuing to explore alternative methods of providing such coverage. The Department is studying a possible self insured PMI coverage program for new CalVet borrowers whose loan to value (LTV) exceeds 80%. In addition, the Department has completed the arduous process of applying to become an approved Federal Housing Agency (FHA) Lender. Once FHA gives its final approval, this would allow the Department to insure loans with FHA. These two items will help to bridge the gap in available PMI coverage.

Monitoring of Insurance Companies

As a result of the economic situation affecting insurance carriers and the country for the past two years, the Department has continued to carefully monitor the financial integrity of the primary insurance carrier for the CalVet Disaster Indemnity Fund, AIG - Lexington Insurance Company of Boston. Lexington has a Best's Key Rating Guide Rating of A XV (A-15). During our review prior to the renewal with Lexington in February 2010, we concluded that the company's rates were excellent and that their claims paying ability was still highly rated and that we should continue to do business with them.

Pending Property Insurance Program Change

For the past 18 months, the Department has been reviewing and analyzing the option of moving the CalVet Property Insurance program from the Commercial Excess Insurance marketplace to the Reinsurance marketplace. Our broker, Marsh of San Francisco and their sister firm, Guy Carpenter Reinsurance Brokers of Seattle, have done the research and analysis. Based upon their analysis we plan to combine the Fire & Hazard and Disaster Indemnity property insurance into one Reinsurance program with a projected annual premium savings of over \$1 million. The tentative effective date for the implementation of this change is August 15, 2010. This major change is made possible, in part, due to the implementation of the CalVet Pooled Self Insurance Fund under AB 1071 by Fletcher in 2009.

CalVet Pooled Self Insurance Fund

In October 2009 the Governor signed AB 1051, Fletcher, which was sponsored by the Department and established the CalVet Pooled Self-Insurance Fund in Military & Veterans Code Sections 989 and 989.1. This statute provides that the following CalVet self insured programs will be pooled:

- 1) The Disaster Indemnity Fund, as authorized in M&V Section 989.4;
- 2) The Fire & Hazard insurance account, as authorized in 987.74 and 987.76;
- 3) The Self Insured (Legacy-vested) Life & Disability program authorized in 987.25 and 987.88; and
- 4) The Mortgage Reserve (aka Primary Mortgage Insurance) program authorized in 987.71 and 987.76.

Under the provisions of this statute, the Department will combine the moneys from the four funds into one fund effective July 1, 2010. This will allow for the sharing of reserves of the four accounts, and in the event of multiple major disasters, protect the CalVet Home Loan Program's operating fund and the Farm and Home Building Fund of 1943 (the 1943 Fund) from the risk of defaulting on bond debt service payments. All funds will be audited on a biennial basis. This audit will assure that each sub-fund is financially solvent and if there is intra-fund borrowing to make sure that these funds are made whole within three years. This audit will also help to adjust rates so that each sub-fund can continue being financially sound.

Fire and Hazard Real Property Insurance

Fire and Hazard insurance is provided to CalVet contract purchasers with the primary portion of the risk self-funded and supported by the Farm and Home Purchases Fund of 1943. Excess insurance is purchased to protect our property portfolio against unexpected, high-loss occurrences under a one-year master policy issued by the Allianz Insurance Company, which is a highly rated company. The coverage year for our Fire and Hazard program is from October 31 to October 31. The excess insurance policy contract discussed in this report became effective October 31, 2009. This insurance is an all-physical loss form and includes standard policy exclusions, including exclusions of earthquake and flood losses. Certificates are issued annually under the master policy to cover individual CalVet homes and farm properties.

Mobile/manufactured homes, both in parks and on land owned by the contract purchaser, are excluded from this coverage. Purchasers of mobile/manufactured homes must obtain fire and hazard coverage from another source, with CDVA named as the loss payee. Also excluded are condominiums and planned-unit development (PUD) properties, which are covered by blanket insurance policies, provided by homeowners' associations that protect our portfolio against losses by way of a Loss Payable Endorsement Clause.

Additionally, under a separate contract between CDVA and Donald K. Sams and Associates, Inc. (Sams), an independent adjusting company, Sams is authorized and responsible to adjust claims and issue the claim payment drafts for losses to CalVet properties protected under the Fire and Hazard Program.

Premiums paid by our contract holders are maintained in a self-insured retention fund to cover losses up to \$2 million per occurrence, with a \$10 million annual aggregate deductible. Our excess insurance carriers would be responsible to pay losses that exceed \$2 million per occurrence, which protects CalVet from catastrophic losses. Additionally, the CalVet properties covered through the Fire and Hazard Program are provided Guaranteed Replacement Cost coverage. Guaranteed Replacement Cost ensures a CalVet contract holder will be able to fully replace the insured home with like kind and quality in the event of a loss, regardless of the stated dollar limits of insurance coverage for the home. However, outbuildings such as work sheds or barns are protected on an "actual cash value" (ACV) basis and not the full replacement cost.

The current annual cost to the CalVet contract holder for Fire and Hazard insurance is \$1.45 per \$1,000 of insured value. This rate has not changed since February 1, 2007, when it was

reduced from \$2.20 per \$1,000 of insured value, which was a reduction in premium of \$0.75 per \$1,000 of replacement cost value. It should be noted that some major insurance companies have raised premium rates for homeowners insurance and often cancel coverage or refuse to renew if the insured has had three or more losses within the previous five years. CalVet does not increase premiums or cancel coverage on individual contract purchasers due to the number of claims filed. Many companies charge higher premiums in high-risk areas; CalVet does not.

The premium paid by the CDVA on October 31, 2009, for the excess coverage was \$612,656. Premiums paid by CalVet contract holders (into the self-insured retention fund) during the 2009/2010 fiscal year totaled \$4,280,779. Actual paid Fire and Hazard claims and expenses during the 2009/2010 fiscal year totaled \$3,051,963, which calculates into a combined loss ratio of 71.3%. See below for more detailed information.

The total cost to operate the Fire and Hazard insurance program, exclusive of departmental personnel costs for administering the program during the 2009/2010 fiscal year, was \$3,051,963, which is based upon the following information:

• Paid claims	\$2,205,515
• Claims Adjusting Service Fees (Fire & H.) (Sams)	\$ 241,887
• Commercial Excess Property Insurance (Marsh)	\$ 612,656
• Less Recoveries from Subrogation	\$ (8,095)
Total	\$3,051,963

This includes adjusting costs, excess policy premium, claims expenses, legal fees (if any) and administrative fees, less subrogation recoveries, but excluding any future change in reserve estimates for losses incurred but not reported at the end of the year. The Department's Operating Fund would be used to cover any shortfalls between premiums collected from contract holders and operating costs. For fiscal year 2009/2010, the net gain to operate the Fire and Hazard Insurance program was \$1,228,816 (4,280,779 – 3,051,963).

The Department updated replacement cost values in January 2006 on all CalVet homes, and continues to update property valuations. This valuation process is beneficial to the ongoing solvency of the insurance programs and equalized what our contract holders pay for their Fire and Hazard and DIC coverages.

The CalVet Fire and Hazard property program continues to cover losses that are usually excluded or limited by most private insurance companies. One example is mold remediation coverage. The CalVet Fire and Hazard program covers mold remediation up to \$20,000 if the ensuing mold damage is caused by a covered peril, whereas commercial insurers are setting coverage limits of \$5,000 to \$10,000 on such losses. The CalVet Fire and Hazard coverage is truly another benefit for the veterans we serve.

Disaster Indemnity Coverage

The Statutes of 1971 authorized Disaster Indemnity Coverage (DIC). Section 989.4 of the Code requires the CDVA to maintain an Indemnity Fund. The fund indemnifies CalVet contract holders against the cost of repairing damage caused by flood, earthquake or other perils, such as mudslide, which are not covered by the Fire and Hazard insurance policy. The deductible per occurrence for every CalVet contract holder is \$500 for flood and \$500 or 5 percent of the covered loss, whichever is greater, for earthquake. (Most commercial insurers apply a 10 to 15 percent deductible to the replacement cost *value of the home, rather than on the covered loss*. Thus, in the case of a partial loss, the CalVet deductible provides much better coverage for the homeowner.) CalVet contract holders participate in the DIC by paying an annual assessment of \$1.50 per \$1,000 of replacement cost (insured) value, which is deposited in the Indemnity Fund.

To cover unexpected catastrophic losses, which may exceed the Indemnity Fund's self-insured retention, CDVA purchases group catastrophe insurance. Coverage for the 2009/2010 fiscal year was placed with commercial insurance companies in the amount of \$50 million with a self-insured retention of \$4 million per occurrence and a \$100,000 per occurrence maintenance deductible thereafter. The current program provides layered coverage between several different providers. Companies subject to greater loss exposure charge more per dollar of coverage because they must pay losses up to their total coverage as soon as the \$4 million deductible per occurrence is breached. The premium paid by CDVA for excess insurance to cover the Disaster Indemnity Program for the Policy Year from February 28, 2010 to February 28, 2011 was \$3,847,166.

Annually, CalVet contract holders pay their pro-rata share to replenish the Disaster Indemnity Fund to cover the self-insured retention and deductible and pay the annual premiums for the excess commercial insurance coverage. Effective February 1, 2007, the annual rate was increased to \$1.50 per \$1,000 of insured value in order to cover the increased costs of claims and excess insurance premiums.

In the event the costs of disasters during a policy year exceed the \$4 million per occurrence the excess coverage will assume additional claims losses up to \$50 million. The Disaster Indemnity Fund would be liable for the balance that exceeds \$50 million. In the event that the DIC fund could not cover such losses, additional assessments from CalVet contract holders would be sought to replenish the Indemnity Fund. This has not occurred since the inception of the DIC program in 1971.

The costs to CalVet contract holders for the DIC are substantially less than similar coverage available through commercial insurance plans. In fact, there are no known coverages offered that can compare to the CalVet DIC Program. Guaranteed-replacement coverage on earthquake losses is not provided or offered by any other insurance company, including the California Earthquake Authority. Most earthquake deductibles are 10 percent to 15 percent of the policy coverage amount, which in most cases is a minimum of \$10,000. All CalVet properties, including mobile homes and condominiums and planned-unit developments with blanket insurance policies, are covered under the DIC program.

During the 2009-2010 fiscal year due to various mild quakes throughout the state, the amount disbursed on behalf of our DIC claimants totaled \$171,364. Premiums received from CalVet contract holders totaled \$4,801,163. The cost to operate the DIC, exclusive of the personnel cost for CDVA staff administering the program, but including the premium for excess commercial insurance coverage, claims payments, adjusting fees and claims expenses was \$4,071,613, which is based upon the following information:

• Commercial Excess Disaster Insurance (EQ & Flood)(Marsh)	\$3,847,166
• Claims Payments	\$ 171,363
• Claims Adjusting Fee (Sams)	\$ 27,009
• Claims Expenses	\$ 26,075
Total	\$4,071,613

For Fiscal Year 2009/2010, the Disaster Indemnity program had a net gain of \$729,550 (\$4,801,163 - \$4,071,613). The Disaster Indemnity Fund balance on June 30, 2010, was \$13,431,734.

Self-Insured Life and Disability Coverage

The Home Protection Plan (HPP), comprised of self-funded life and disability coverage provided by the CDVA through a fund administered by the Pacific Life and Annuity Company (PLA), was discontinued on June 1, 1996. Only the CalVet loan holders who were disabled and qualified for disability benefits on that date remain in the vested legacy program. They will continue to be covered until they are no longer disabled or until the loan balance is paid in full. As of June 30, 2010, there were 70 loan holders receiving monthly self-funded disability benefits. Standard Insurance Company administers the HPP for CalVet. CDVA discontinued offering the self funded life and disability coverage to new loan holders on January 1, 1995, because of the extraordinary losses being experienced by the program.

During fiscal year 2009/2010, the Department paid a total of \$6,196 for the life coverage on behalf of the CalVet contract holders receiving self-funded disability benefits. Charges for life coverage for these contract holders are part of the installments paid by the coverage benefit, and are paid by the self-funded HPP reserve funds. Life claims for 4 participants totaled \$25,413.

During fiscal year 2009/2010, the Department paid a total of \$22,348 for the disability coverage on behalf of the CalVet contract holders receiving self-funded disability benefits. As a part of their disability benefit, these amounts are charged against the self-insured HPP reserve funds. Disability claims paid to participants during fiscal year 2009/2010, including the pay off of 106 loans by the Department from the Self Insured reserve fund, totaled \$3,180,530. As of June 30, 2010, the reserve fund for the legacy self insured program contains \$2,819,389, which will be used to pay for future disability and death benefits. Actuaries at Standard Insurance Company have completed calculations for the 70 loan holders still in the legacy self-insured portion of the CalVet portfolio. (Note: The actuaries at Standard used the 1987 Group Commissioners Table, at 5% interest, to generate the liability calculation). As of June 30, 2010, the liability is estimated to be \$1,710,792, and we have set aside \$2,819,389 to fund the outstanding liability.

The administrative cost paid to The Standard to operate the HPP for disability coverage totaled \$9,416 for fiscal year 2009/10, exclusive of the costs of Department personnel administering the program. These costs will continue to decrease due to a reduction in the number of veterans covered by the legacy self-funded program and the substantial reduction in administrative fees as outlined in the Administrative Services Agreement dated February 1, 2003 and renewed on February 1, 2008, with Standard Insurance Company.

Commercial Life and Disability Insurance

Under the plan with Standard Insurance Company that became effective on February 1, 2003, Standard was paying CDVA an administrative fee of 4 percent of the amount of premiums paid on life and disability coverage. Effective February 1, 2008, the new contract with Standard provides, at the option of CDVA, that this administrative fee of 4% would be deposited monthly into the CalVet Claims Fluctuation Reserve (CFR) account at the Bank of New York - Mellon (BNY - Mellon) for the purpose of helping to stabilize our life and disability insurance rates. If necessary, Standard Insurance can draw funds from this account to stabilize the life and disability insurance program. In October 2009, CDVA redirected the 4% administrative fee from the CFR account to CDVA to offset the Department's expenses for billing and collecting premiums from contract holders and the premium costs of coverage on delinquent contracts until their loan payments are current, or their loan contracts are cancelled. The total amount of the administrative fee for 2009/2010 was \$174,899.45. Of that sum, the amount credited to the CFR account at BNY Mellon was \$59,738.96, and \$115,160.49 was refunded to the Department.

Loan Insurance

Since 1997, the Department has completed several programmatic changes, including obtaining loan insurance from a primary mortgage insurer (PMI) for certain existing Contracts of Purchase with high loan-to-value ratios (LTVs), and United States Department of Veterans Affairs (USDVA) loan guarantees or primary mortgage insurance for all new Contracts of Purchase (except home improvement loans) with LTVs above 80 percent.

During 2007/08 FY, the rating agencies downgraded all PMI companies because of the housing crisis. In addition, because of the high number of foreclosures in California, the PMI companies have essentially stopped writing policies in the state. This renders PMI companies of little value in supporting CalVet bond ratings. The Department is exploring alternative methods of providing such coverage. A study is underway regarding a possible self-insured PMI coverage program for new CalVet borrowers whose LTV exceeds 80%. The lack of availability of commercial PMI may make it difficult to make some loans to prospective borrowers, and this is true for all segments of the California mortgage market place. In addition to self-insurance, the Department has completed the arduous task of applying to become an approved FHA Lender. This would allow the Department to insure loans with FHA. Such action will help to fill the gap in available PMI coverage. The Department continues to pursue options of how to reduce PMI costs for the Department, which will ultimately reduce the up-front costs for veterans acquiring new loans.

USDVA Guaranty Program

The Department was approved by the USDVA as a "supervised lender with automatic processing authority" as of March 10, 1998, which means we can process and fund loans prior to getting approval from USDVA. On July 27, 1998, the Department received USDVA approval under the Lender Appraisal Processing Program to process appraisals and determine reasonable value without prior USDVA review. The Department seeks USDVA loan guarantees for Contracts of Purchase with an LTV of 80 percent or higher, up to 100 percent.

The Department collects and pays to the USDVA a funding fee between 1.25 percent and 3.3 percent of the Contract of Purchase (loan) amount, based on the LTV for each Contract of Purchase on all contracts to be guaranteed by the USDVA. The buyer or the seller may pay this fee in escrow, or it may be added to the base loan amount, not to exceed the \$521,250 maximum loan amount with the funding fee added. For Contracts of Purchase with LTVs exceeding 80% that are not insured by USDVA, a funding fee between 1.25% and 3.3% of the base loan amount is collected at close of escrow and is deposited into the CDVA self insured PMI account (Loan Guarantee Fee account). For these contracts the funding fee may not be added to the base loan amount.

Primary Mortgage Insurance (PMI)

In 1998 and 1999, the Department purchased mortgage insurance from Radian for a pool of existing Contracts of Purchase with LTVs above 80 percent. The Department purchased primary mortgage insurance from Radian on all new Contracts of Purchase (except home improvement loans) with LTVs between 80 percent and 97 percent that are not guaranteed by the USDVA. Under this agreement, as amended on December 13, 2006, Radian committed to insure Contracts of Purchase until the aggregate principal amount of Contracts of Purchase insured under the second policy and subsequent amendment reaches \$3.6 billion.

The Radian policies provide for coverage for aggregate losses incurred on Contracts of Purchase following property disposition above an aggregate 2 percent deductible based upon a percentage of the original insured balances of the Contracts of Purchase of the applicable pool. Under both Radian policies, once the applicable aggregate deductible has been reached, insurance claims may be made. Until the spring of 2008, a funding fee of up to 1.38 percent of the base loan amount was collected at close of escrow and used to purchase the Radian coverage. For these contracts the funding fee may not be added to the base loan amount.

Due to changes in the economic stability of Primary Mortgage Insurance (PMI) companies, the Department felt the need to find other avenues for PMI coverage. (Note: the Department takes its underwriting process seriously. With that in mind, we are making secure loans and, it should be noted, foreclosure losses are far below all other California figures. Therefore, we have not underwritten or devised loan products that have added to the PMI coverage meltdown.) Since we are in the process of devising other options to cover foreclosure losses, such as underwriting FHA backed loan products, the decision was made to discontinue paying premiums to Radian, and to self-insure that portion of our portfolio. For Contracts of Purchase with LTVs exceeding 80% that are not insured by USDVA, a funding fee between 1.25% and 3.3% of the base loan amount is collected at close of escrow and is deposited into the CDVA self insured PMI account (Loan Guarantee Fee account). To date, we have accumulated \$5,399,055.51 in the self-insured fund that will be used to pay for upcoming losses to that portion of the CalVet portfolio. Radian still covers 3,191 homes in the CalVet portfolio.

CalVet Insurance Unit

The entire CalVet Insurance Unit - Home Protection Program is administered internally in the Farm and Home Purchases Division by seven people (6.5 positions). This includes: one unit manager; three Associate Property Agents; one Associate Program Analyst; one program technician and one retired annuitant. The total staff budget allocation for fiscal year 2009/10 was \$604,211, including salaries and wages, staff benefits, operating expenses and equipment.

Conclusion

All of the Home Protection programs are financially stable, and we look forward to them continuing to be solvent for the next five years, with only minor revisions. As this report is being written, the Department continues investigating alternatives and options to commercial PMI, which essentially has not been available in the California market place as of April 2008.